III. MARRIAGE PENALTY RELIEF PROVISIONS

A. STANDARD DEDUCTION MARRIAGE PENALTY RELIEF (SEC. 2 OF H.R. 6, SEC. 301 OF THE SENATE AMENDMENT AND SEC. 63 OF THE CODE)

PRESENT LAW

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A ''marriage penalty'' exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A ''marriage bonus'' exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable),[11] which is subtracted from adjusted gross income (''AGI'') in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation. For 2001, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns. Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

HOUSE BILL

No provision. However, H.R. 6, as passed by the House, contains a provision that increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same.

Effective date.—The provision is effective for taxable years beginning after December 31, 2001.

SENATE AMENDMENT

The Senate amendment is the same as H.R. 6 except that the increase in the standard deduction is phased-in over five years beginning in 2005 and would be fully phased-in for 2009 and thereafter. Table 13, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

Table 13.—Phase-In of Increase of Standard Deduction for Married Couples Filing Joint Returns

Calendar Year	*Standard Deduction for Joint Returns as Percentage of Standard Deduction for Single Returns*
2005	174%
2006	184%
2007	187%
2008	190%
2009 and later	200%

Effective date.—The provision is effective for taxable years beginning after December 31, 2004.

CONFERENCE AGREEMENT

The conference agreement follows the Senate amendment.

B. EXPANSION OF THE 15-PERCENT RATE BRACKET FOR MARRIED COUPLES FILING JOINT RETURNS (SEC. 3 OF H.R. 6, SEC. 302 OF THE SENATE AMENDMENT AND SEC. 1 OF THE CODE)

PRESENT LAW

In general

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.[12] The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

HOUSE BILL

No provision. However, H.R. 6, as passed by the House, contains a provision that increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. This increase is phased in over six years as shown in Table 15, below. Therefore, this provision is fully effective (i.e., the size of the lowest regular income tax rate bracket for a married couple filing a joint return is twice the size of the lowest regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2008.

Table 15.—Increase in Size of 15-Percent Rate Bracket for Married Couples Filing a Joint Return

Taxable year	*Size of 15-percent rate bracket for married couple filing joint return as percentage of rate bracket for unmarried individuals*
2004	172%
2005	178%
2006	183%
2007	189%
2008	195%
2009 and thereafter	200%

Effective date.—The provision is effective for taxable years beginning after December 31, 2003.

SENATE AMENDMENT

The Senate amendment increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. The increase is phased-in over five years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return would be twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2008. Table 16, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

[11] Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

[12] The rate bracket breakpoint for the 39.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

Table 16.—Increase in Size of 15-Percent Rate Bracket for Married Couples Filing a Joint Return

Taxable year	*End point of 15-percent rate bracket for married couple filing joint return as percentage of end point of 15-percent rate bracket for unmarried individuals*
2005	174%
2006	184%
2007	187%
2008	190%
2009 and thereafter	200%

Effective date.—The provision is effective for taxable years beginning after December 31, 2004.

CONFERENCE AGREEMENT

The conference agreement increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. The increase is phased-in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return would be twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2007. Table 17, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

Table 17.—Increase in Size of 15-Percent Rate Bracket for Married Couples Filing a Joint Return

Taxable year	*End point of 15-percent rate bracket for married couple filing joint return as percentage of end point of 15-percent rate bracket for unmarried individuals*
2005	180%
2006	187%
2007	193%
2008 and thereafter	200%

Effective date.—The provision is effective for taxable years beginning after December 31, 2004.

C. MARRIAGE PENALTY RELIEF AND SIMPLIFICATION RELATING TO THE EARNED INCOME CREDIT (SEC. 2(B)(2) OF THE HOUSE BILL, SEC. 4 OF H.R. 6, SEC. 303 OF THE SENATE AMENDMENT, AND SEC. 32 OF THE CODE)

PRESENT LAW

In general

Eligible low-income workers are able to claim a refundable earned income credit. The amount of the credit an eligible taxpayer may claim depends upon the taxpayer's income and whether the taxpayer has one, more than one, or no qualifying children.

The earned income credit is not available to married individuals who file separate returns. No earned income credit is allowed if the taxpayer has disqualified income in excess of $2,450 (for 2001) for the taxable year.[13] In addition, no earned income credit is allowed if an eligible individual is the qualifying child of another taxpayer.[14]

Definition of qualifying child and tie-breaker rules

To claim the earned income credit, a taxpayer must either (1) have a qualifying child or (2) meet the requirements for childless adults. A qualifying child must meet a relationship test, an age test, and a residence test. First, the qualifying child must be the taxpayer's child, stepchild, adopted child, grandchild, or foster child. Second, the child must be under age 19 (or under age 24 if a full-time student) or permanently and totally disabled regardless of age. Third, the child must live with the taxpayer in the United States for more than half the year (a full year for foster children).

An individual satisfies the relationship test under the earned income credit if the individual is the taxpayer's: (1) son or daughter or a descendant of either;[15] (2) stepson or stepdaughter; or (3) eligible foster child. An eligible foster child is an individual (1) who is a brother, sister, stepbrother, or stepsister of the taxpayer (or a descendant of any such relative), or who is placed with the taxpayer by an authorized placement agency, and (2) who the taxpayer cares for as her or his own child. A married child of the taxpayer is not treated as meeting the relationship test unless the taxpayer is entitled to a dependency exemption with respect to the married child (e.g., the support test is satisfied) or would be entitled to the exemption if the taxpayer had not waived the exemption to the noncustodial parent.[16]

If a child otherwise qualifies with respect to more than one person, the child is treated as a qualifying child only of the person with the highest modified adjusted gross income.

''Modified adjusted gross income'' means adjusted gross income determined without regard to certain losses and increased by certain amounts not includible in gross income.[17] The losses disregarded are: (1) net capital losses (up to $3,000); (2) net losses from estates and trusts; (3) net losses from nonbusiness rents and royalties; (4) 75 percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than farming), farming sole proprietorships, and other businesses. The amounts added to adjusted gross income to arrive at modified adjusted gross income include: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement plans (but not nontaxable rollover distributions or trustee-to-trustee transfers).

Definition of earned income

To claim the earned income credit, the taxpayer must have earned income. Earned income consists of wages, salaries, other employee compensation, and net earnings from self employment.[18] Employee compensation includes anything of value received by the taxpayer from the employer in return for services of the employee, including nontaxable earned income. Nontaxable forms of compensation treated as earned income include the following: (1) elective deferrals under a cash or deferred arrangement or section 403(b) annuity (sec. 402(g)); (2) employer contributions for nontaxable fringe benefits, including contributions for accident and health insurance (sec. 106), dependent care (sec. 129), adoption assistance (sec. 137), educational assistance (sec. 127), and miscellaneous fringe benefits (sec. 132); (3) salary reduction contributions under a cafeteria plan (sec. 125); (4) meals and lodging provided for the convenience of the employer (sec. 119), and (5) housing allowance or rental value of a parsonage for the clergy (sec. 107). Some of these items are not required to be reported on the Wage and Tax Statement (Form W–2).

Calculation of the credit

The maximum earned income credit is phased in as an individual's earned income increases. The credit phases out for individuals with earned income (or if greater, modified adjusted gross income) over certain levels. In the case of a married individual who files a joint return, the earned income credit both for the phase-in and phase-out is calculated based on the couples' combined income.

The credit is determined by multiplying the credit rate by the taxpayer's earned income up to a specified earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The maximum credit amount applies to taxpayers with (1) earnings at or above the earned income amount and (2) modified adjusted gross income (or earnings, if greater) at or below the phase-out threshold level.

For taxpayers with modified adjusted gross income (or earned income, if greater) in excess of the phase-out threshold, the credit amount is reduced by the phase-out rate multiplied by the amount of earned income (or modified adjusted gross income, if greater) in excess of the phase-out threshold. In other words, the credit amount is reduced, falling to $0 at the ''breakeven'' income level, the point where a specified percentage of ''excess'' income above the phase-out threshold offsets exactly the maximum amount of the credit. The earned income amount and the phase-out threshold are adjusted annually for inflation. Table 18, below, shows the earned income credit parameters for taxable year 2001.[19]

TABLE 18.—EARNED INCOME CREDIT PARAMETERS (2001)

	Two or more qualifying children	One qualifying child	No qualifying children.
Credit rate (percent)	40.00%	34.00%	7.65%
Earned income amount	$10,020	$7,140	$4,760
Maximum credit	$4,008	$2,428	$364
Phase-out begins	$13,090	$13,090	$5,950
Phase-out rate (percent)	21.06%	15.98%	7.65%
Phase-out ends	$32,121	$28,281	$10,710

An individual's alternative minimum tax liability reduces the amount of the refundable earned income credit.[20]

HOUSE BILL

The House bill provides that the earned income credit will no longer be reduced by the amount of the alternative minimum tax. The same provision is included in H.R. 6, as passed by the House.

In addition, H.R. 6 increases the earned income amount used to calculate the earned income credit for married taxpayers who file a joint return to 110 percent of the earned income amount for all other taxpayers eligible for the earned income credit.

H.R. 6 also simplifies the definition of earned income by excluding nontaxable earned income amounts from the definition of earned income for earned income credit purposes. Thus, under H.R. 6, earned income includes wages, salaries, tips, and other employee compensation, if includible in gross

[13] Sec. 32(i). Disqualified income is the sum of: (1) interest and dividends includible in gross income for the taxable year; (2) tax-exempt income received or accrued in the taxable year; (3) net income from rents and royalties for the taxable year not derived in the ordinary course of business; (4) capital gain net income for the taxpayer year; and (5) net passive income for the taxable year. Sec. 32(i)(2).

[14] Sec. 32(c)(1)(B).

[15] A child who is legally adopted or placed with the taxpayer for adoption by an authorized adoption agency is treated as the taxpayer's own child. Sec. 32(c)(3)(B)(iv).

[16] Sec. 32(c)(3)(B)(ii).

[17] Sec. 32(c)(5).

[18] Sec. 32(c)(2)(A).

[19] The table is based on Rev. Proc. 2001–13.

[20] Sec. 32(h).

income for the taxable year, plus net earnings from self-employment.

Effective date.—The House bill is effective for taxable years beginning after December 31, 2000.

SENATE AMENDMENT

For married taxpayers who file a joint return, the Senate amendment increases the beginning and ending of the earned income credit phase-out by $3,000. These beginning and ending points are to be adjusted annually for inflation after 2002.

The Senate amendment simplifies the definition of earned income by excluding nontaxable employee compensation from the definition of earned income for earned income credit purposes. Thus, under the Senate amendment, earned income includes wages, salaries, tips, and other employee compensation, if includible in gross income for the taxable year, plus net earnings from self employment.

The Senate amendment repeals the present-law provision that reduces the earned income credit by the amount of an individual's alternative minimum tax.

The Senate amendment simplifies the calculation of the earned income credit by replacing modified adjusted gross income with adjusted gross income.

The Senate amendment provides that the relationship test is met if the individual is the taxpayer's son, daughter, stepson, stepdaughter, or a descendant of any such individuals.[21] A brother, sister, stepbrother, stepsister, or a descendant of such individuals, also qualifies if the taxpayer cares for such individual as his or her own child. A foster child satisfies the relationship test as well. A foster child is defined as an individual who is placed with the taxpayer by an authorized placement agency and who the taxpayer cares for as his or her own child. In order to be a qualifying child, in all cases the child must have the same principal place of abode as the taxpayer for over one-half of the taxable year.

The Senate amendment changes the present-law tie-breaking rule. Under the Senate amendment, if an individual would be a qualifying child with respect to more than one taxpayer, and more than one taxpayer claims the earned income credit with respect to that child, then the following tie-breaking rules apply. First, if one of the individuals claiming the child is the child's parent (or parents who file a joint return), then the child is considered the qualifying child of the parent (or parents). Second, if both parents claim the child and the parents do not file a joint return together, then the child is considered a qualifying child first of the parent with whom the child resided for the longest period of time during the year, and second of the parent with the highest adjusted gross income. Finally, if none of the taxpayers claiming the child as a qualifying child is the child's parent, the child is considered a qualifying child with respect to the taxpayer with the highest adjusted gross income.

The Senate amendment authorizes the IRS, beginning in 2004, to use math error authority to deny the earned income credit if the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of the child with respect to whom the credit is claimed.

It is the intent of the Senate that by September 2002, the Department of the Treasury, in consultation with the National Taxpayer Advocate, deliver to the Senate Committee on Finance and the House Committee on Ways and Means a study of the Federal Case Registry database. The study is to cover (1) the accuracy and timeliness of the data in the Federal Case Registry, (2) the efficacy of using math error authority in this instance in reducing costs due to erroneous or fraudulent claims, and (3) the implications of using math error authority in this instance, given the findings on the accuracy and timeliness of the data.

Effective date.—The Senate amendment generally is effective for taxable years beginning after December 31, 2001. The Senate amendment to authorize the IRS to use math error authority if the Federal Case Registry of Child Support Orders indicates the taxpayer is the noncustodial parent is effective beginning in 2004.

CONFERENCE AGREEMENT

The conference agreement follows the Senate amendment, except under the conference agreement, for married taxpayers filing a joint return, the earned income credit phase-out amount is increased as follows: by $1,000 in the case of taxable years beginning in 2002, 2003, and 2004; by $2,000 in the case of taxable years beginning in 2005, 2006, and 2007; and by $3,000 in the case of taxable years beginning after 2007. The $3,000 amount is to be adjusted annually for inflation after 2008.

The conferees realize that the expansion of the earned income credit may create a financial hardship on U.S. possessions with mirror codes and that further study of such effects is necessary.

[21] As under present law, an adopted child is treated as a child of the taxpayer by blood.